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Supreme Court of the United States

October Term, 1942

No. 129

MORRIS INVESTMENT CORPORATION
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

REPLY BRIEF OF PETITIONER.

EDWARD L. BLACKMAN,
Counsel for Petitioner,
120 Broadway,
New York, New York.



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I. Opinions of the Court Below.

The memorandum opinion of the United States Board of Tax Appeals (R. 29-34) promulgated July 25, 1942 was not reported (46 B. T. A. 1276). The opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 35) is reported in 134 Federal Section 774.

II. Jurisdiction.

The statutory provision believed by Petitioner to sustain the jurisdiction of this Court is Section 240 of the Judicial Code as amended by the act of February 13, 1925. 43 Stat. 938; 24 U. S. C. Section 347.

III. Questions Presented.

These questions are set out in Petitioner's main Brief (p. 10). They are:

1. Whether or not the deficiency assessed against the Petitioner for Personal Holding Company Surtax violated the Federal Constitution, Amendments 5 and 14.

2. Whether the deficiency in Personal Holding Company Surtax assessed against Petitioner for the year 1937 is not rendered void by the provisions of the Revenue Act of 1942, particularly Section 501a thereof wherein it amends the provisions of Section 26c and Section 26 of the Revenue Act of 1936.

IV. Statutes Involved.

The pertinent statutes are set forth in appendix to Petitioner's main Brief, pages 30 to 33, and in the appendix of Respondent's Brief, pages 9 to 11.

V. Statement.

Statement of the case is set out in Petitioner's main Brief, pages 11 to 15.

VI. Argument.

1. Respondent's Answer to Petitioner's Point A is no answer at all. It ignores the argument set out in Petitioner's main Brief, pages 17 to 24, and merely states that Sections 14(a)2 and 26(c) of the Revenue Act of 1936 deal only with the surtax on undistributed profits and not with the surtax on Personal Holding Companies. No reason for this statement is given by Respondent and it is

in fact incorrect. Section 26 of the Revenue Act of 1936 relates not only to corporations subject to the Undistributed Profits Surtax but to the credits of any corporation. Section 26 (which is amended by the Act of 1942) is found in all the Revenue Acts, even after the Undistributed Surtax was repealed in 1938. It applies to all corporations and provides for the credits allowed corporations. It was to this section that the Revenue Act of 1942 added a subdivision "(f)", providing an additional credit to so-called "deficit corporations". There is absolutely no reason for saying that this subsection applies only to Undistributed Profits Surtaxes when justice and equity both point towards the intent of Congress to allow this credit in the case of all corporations, including Personal Holding Companies, and particularly since Congress put no limitation on the application of the new subsection.

That Section 26 applies as well to Personal Holding Companies as to other Companies is indicated from the further fact that in the section itself in defining and fixing the amount of the credit allowed, it is stated that the earnings and profits shall be computed without diminution by the amount of the tax imposed under certain stated sections, the last of which is Section 351, and Section 351 is the one which imposes the Personal Holding Company Surtax. Therefore, the argument of the respondent resolves itself into a contention that although Section 26(f), by its own terms applies to Personal Holding Corporations, it does not confer upon these same Personal Holding Corporations the benefit of the credits allowed therein. No such unfair and unreasonable intent should be imputed to Congress.

2. The Respondent argues that the same objections to the Constitutionality of the Personal Holding Company Surtax made by Petitioner have been considered and rejected by this Court in upholding the Undistributed Profits

Surtax on corporations, and cites the cases of *Helvering v. Northwest Steel Mills*, 311 U. S. 46, and *Crane-Johnson Co. v. Helvering*, 311 U. S. 54.

The questions presented in those cases were entirely different from those presented here. Neither of those taxpayers was a personal holding corporation, neither had a deficit at the beginning of the tax year together with a loss during the tax year and neither had an actual loss though a statutory "net income" during the tax year. Those are the facts with respect to Petitioner and upon which it relies.

If Northwest Steel Mills Co. or Crane-Johnson Co. had paid out to its stockholders the undistributed profits upon which it was assessed it would have violated the laws of the state of its incorporation but such distributions would have been taxable to its stockholders as dividends and it would have relieved itself of the undistributed profits tax. This follows because Section 115(a) of the Revenue Act of 1936 enlarged the scope of the definition of "dividend" to include any distribution "out of earnings and profits of the taxable year".

That situation is entirely different from the situation in which Petitioner found itself. Petitioner had statutory income for the year 1937 from dividends from stocks owned by it, but it had a loss of capital assets from the sale of some of those stocks at a loss. This loss wiped out its entire "earnings and profits of the taxable year" but it reduced its "net income" by only \$2,000. (Secs. 21, 22 and 23; Sec. 351 (b) of the Revenue Act of 1936.)

"Net income" is a statutory concept and may differ widely from an actual gain. "Earnings and profits", on the other hand, have the meaning which is ordinarily attached to those words. (*Commissioner v. Young Corporation*, 103 F. (2d) 137.)

Thus, while Petitioner had taxable net income for the year 1937, it had no "earnings or profits" for that year or for any previous year. Hence the payment by Petitioner to its stockholders of its statutory income for the tax year 1937 *would not* have relieved Petitioner from the tax upon its undistributed profits. This is made plain by Article 27 of Regulations 94 referred to at pages 17 and 18 of Petitioner's main Brief. This Article provides that "no dividends paid credit is allowed with respect to any distribution unless each of the shareholders * * * receives a taxable dividend as a result of the distribution". Taxable dividends can be paid only from earnings and profits of the taxable year by a corporation having a deficit at the beginning of the taxable year.

Thus, according to the claims of Respondent, the luckless deficit corporation which had a loss at the beginning of the tax year and made an actual loss but a statutory gain during the tax year, not only has to pay an income tax upon a gain which is statutory only, but has to pay a 75% undistributed profits tax upon purely theoretical profits for failure to pay out to its stockholders taxable dividends when it cannot possibly make such payment.

If the claim of Respondent is correct each Personal Holding Corporation which had sold capital assets at a loss during 1937 in reliance upon the privilege which it had enjoyed for many years, would have to pay a withholding tax of 75% upon the amount of such losses unless it had a surplus at the beginning of the tax year equal to, or greater than, such losses, and unless it paid dividends to its stockholders from such surplus equal to such capital losses. If this be the intent of Congress it is clearly in violation of the Constitution and of Amendments 5th and 14th.

In *Foley Securities Corp. v. Commissioner*, 106 Fed. (2d) 731, cited by Respondent, the Court says, with respect

to Section 351 of the Revenue Act of 1934 which was in all respects similar to the Revenue Act of 1936 here under consideration, "There can be no doubt that the purpose of Congress in enacting Section 351 was to compel each personal holding company to distribute its current earnings instead of accumulating them so as to augment the income of its shareholders, thereby increasing the amount of their tax liability" (p. 734).

The Court further states that through an inadvertent omission by Congress, personal holding companies may be taxed in some cases for failure to distribute their statutory income even though the distribution thereof would not carry out the said intent of Congress because not constituting income in the hands of the shareholders (p. 734).

The Court then concludes its statement of the effect of the statute as follows:

"The vice of this statute as we see it is that Congress, in order to induce personal holding companies to distribute their current net earnings, and after placing all such companies in a class for the purpose of imposing a heavy surtax upon such of their current earnings as are not distributed as dividends to shareholders, used a restricted definition of the term 'dividends' in providing how the undistributed earnings should be computed, which had the effect of placing personal holding companies with a capital impairment in a far worse position than those without an impairment of capital, and this for no apparent reason. The result was that the former were penalized and required to pay a surtax upon all or a part of the income received and actually distributed by them, the amount of the surtax depending, of course, upon the extent of the impairment of their capital, so that those with the largest operating deficits were required to pay the largest surtaxes" (p. 735).

The Court stated that the inadvertence of Congress was subsequently corrected. That statement is correct as Congress, in the 1936 Revenue Act, made the term "dividends" include "earnings and profits of the taxable year". However, in 1937 Congress again restored the conditions which the Court criticised in the *Foley* case by denying to personal holding corporations the right to deduct losses from the sale of capital assets which right they had had theretofore, thereby imposing a tax on statutory profits for the year while allowing as a deduction only those payments to stockholders which could qualify as earnings and profits, which as above shown, were not the same thing at all and might be more or less.

It is true that the *Foley* case sustained the constitutionality of the 1934 law upon the ground that there was practically no control over Congress in tax matters and that it could make its taxing provisions as unfair and unreasonable as it chose. However, this decision was not appealed and the question of the validity of the 1934 statute has not been passed upon by this Court. Moreover the tax involved in 1934 was 30%, while in 1937 it was 75% and the admitted unreasonableness of Congress is accentuated to that extent.

The cases of *Noteman v. Welch*, 108 Fed. (2d) 206, and *Girard Inv. Co. v. Commissioner*, 122 Fed. (2d) 843, cited by Respondent (p. 6 of its brief), are not in point. The principal issue in those cases was whether or not the taxpayer was a Personal Holding Company. The question of the validity of the provisions, or rather, of the interpretation placed upon the Personal Holding Company Surtax provisions by the Circuit Court of Appeals in this case, was not passed upon by the Court in the *Noteman* case.

The case of *Simpson & Co. v. Helvering*, 128 Fed. (2d) 742, cited by the Respondent on page 6 of its brief, is not fully reported, but is in the form of a *per curiam* affirmance

on the authority of *Noteman v. Welch, supra*, as to one point, and *O'Sullivan Rubber Co. v. Commissioner*, 120 Fed. (2d) 845, as to another point, neither of which cases are in point.

Conclusion.

The petition for a Writ of Certiorari should be granted and the decision below reversed.

Dated: October 1st, 1943.

EDWARD L. BLACKMAN,
Counsel for Petitioner,
120 Broadway,
New York, New York.

